In the Supreme Court

OF THE

United States

October Term, 1944

No.

Lorin A. Cranson,

Petitioner,

vs.

The United States of America,

Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

JURISDICTION OF THE CASE.

This petition is filed to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit entered January 24, 1945 (R. 75), rehearing denied February 26, 1945 (R. 76), which affirmed the judgment of the United States District Court for the Northern District of California, Southern Division, entered October 25, 1943. (R. 62.) No opinion was filed by the District Court. The opinion of the Circuit Court of Appeals was filed January 24, 1945, is re-

ported at 146 F. (2d) 871, and a copy will be found in the printed Transcript of Record at pages 71 to 74.

The jurisdiction of this Court is invoked under section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925. (Appendix, p. i.)

STATEMENT OF THE CASE.

A summary statement of the case, including the essential facts, is set forth in the foregoing petition at pages 2 to 6.

SPECIFICATION OF ERRORS.

With respect to petitioner's principal contention, the Court below erred as follows:

1. In deciding that the operating deficits of the subsidiary corporations of Honolulu as of the date of their liquidation in 1936 did not diminish the earnings or profits of Honolulu which were otherwise available for dividends.

2. In assuming that it was necessary for petitioner to prove what portion of the deficits of the subsidiaries occurred in the tax year 1936.

With respect to petitioner's alternative contention that the loss actually realized by Honolulu on the liquidation of its subsidiaries in 1936 reduced the earnings of Honolulu available for dividends, the Court below erred as follows:

1. In dismissing said alternative contention without consideration on the ground that there was no showing that any of said loss was incurred in the tax year 1936. It is stipulated that the subsidiaries were liquidated on August 31, 1936, and that upon said liquidation Honolulu realized a loss of $1,225,908.63, the entire amount of the loss in question. (R. 33.)

2. In stating that it is admitted that $931,553.82 earnings or profits were made in 1936 by Honolulu. It is stipulated that these are the earnings before deducting the loss of $1,225,908.63 realized in 1936 upon the liquidation of the subsidiaries. (R. 38.)

3. In failing to determine that section 501 of the Second Revenue Act of 1940, insofar as its application to the facts of this case is concerned, violates the provisions of the Sixteenth Amendment to the Constitution of the United States and the due process clause of the Fifth Amendment to the Constitution of the United States.

SUMMARY OF ARGUMENT.

I. The operating deficits of said subsidiaries were inherited by Honolulu upon the nontaxable liquidation of said subsidiaries.

(a) The principle established by *Commissioner v. Sansome,* 60 F. (2d) 931 (C.C.A. 2), certiorari denied, 287 U. S. 667, and succeeding cases is that nontaxable reorganizations do not break the continuity of the corporate life as a continuing venture, with the result that under the doctrine of

these cases it is held that the earnings or profits of the transferor corporation are transferred intact to the successor or transferee corporation.

(b) Under the doctrine of the *Sansome* case that the continuity of the corporate life as a continuing venture is not broken, no valid distinction can be drawn between operating deficits on the one hand and earnings or profits on the other hand.

(c) Section 501 of the Second Revenue Act of 1940, and the Treasury Regulations expressing the same principles prior to the enactment of this section, will not operate in an equitable manner insofar as nontaxable liquidations of subsidiary corporations are concerned unless the Sansome doctrine applies to operating deficits as well as to earnings.

(d) The Court below erred in assuming that it was necessary for petitioner to prove what portion of the deficits of the subsidiaries occurred in the tax year 1936.

II. If it is held that the operating deficits of said subsidiaries were not inherited by Honolulu, then it is contended in the alternative that the loss realized by Honolulu upon the liquidation of said subsidiaries reduced the earnings of Honolulu available for dividends.

(a) Section 501 of the Second Revenue Act of 1940 in its application to the facts of this case violates the provisions of the Sixteenth Amendment to the Constitution of the United States.

(b) The attempted retroactive application of section 501 of the Second Revenue Act of 1940 violates the due process clause of the Fifth Amendment to the Constitution of the United States.

ARGUMENT.

I.

THE OPERATING DEFICITS OF SAID SUBSIDIARIES WERE INHERITED BY HONOLULU UPON THE NONTAXABLE LIQUIDATION OF SAID SUBSIDIARIES.

The question involved in this petition is the extent to which the stockholders of Honolulu must report as subject to federal income tax certain distributions paid by Honolulu to its stockholders during the calendar year 1936.

The gross income which is subject to the income tax, after the allowance of certain statutory deductions, is defined by section 22(a) of the Revenue Act of 1936 (Appendix, pp. i and ii) (the statute controlling the decision of this petition) to include dividends, and the term dividends is defined by section 115(a) of the Act (Appendix, pp. v and vi) as a distribution out of the "earnings or profits" of a corporation, whether those of the taxable year or those accumulated since March 1, 1913. If a corporation declares dividends out of its earnings or profits, such dividends constitute income to the stockholders upon which they must pay taxes. On the other hand, if the corporation has no earnings or profits available for dividends, or if its dividends exceed the earnings or profits which are available, then

to the extent that the dividends are not paid out of earnings or profits of the corporation such distributions do not constitute income to the stockholders and are received free from tax until such time as the tax-free distributions received exceed the cost of the stock to the stockholders.

(a) The principle established by the Sansome case and succeeding cases is that nontaxable reorganizations do not break the continuity of the corporate life as a continuing venture, with the result that under the doctrine of these cases it is held that the earnings or profits of the transferor corporation are transferred intact to the successor or transferee corporation.

Since the term "earnings or profits" is not defined by the statute, problems have arisen regarding the interpretation to be given this term. One of the earliest situations requiring judicial construction was that arising in connection with the tax-free transfer of the assets and business of one corporation to another corporation. In 1921 a New Jersey corporation transferred all its assets to a new corporation, which assumed the liabilities of the old corporation and issued its shares to the shareholders of the old corporation. Prior to its reincorporation the old corporation had a large earned surplus available for dividends, and if this corporation had paid dividends the stockholders would obviously have paid taxes thereon. After the reincorporation the new corporation paid dividends to its stockholders, who were identically the same persons as the stockholders of the old corporation, and these stockholders contended that the dividends were tax-free, since the new corporation had no earnings of

its own available for dividends. The question thus presented came up for decision in the Circuit Court of Appeals for the Second Circuit in *Commissioner v. Sansome*, 60 F. (2d) 931 (1932), certiorari denied, 287 U. S. 667. That Court, in an opinion by Judge Learned Hand, held that the new corporation had *acquired the earnings of the old corporation* and the dividends were therefore subject to tax. The Court stated that the reincorporation was a nontaxable corporate reorganization under the express provisions of the statute making such reorganizations nontaxable, and came to the conclusion that nontaxable reorganizations do not break the continuity of the corporate life, saying:

> "Hence we hold that a corporate reorganization which results in no 'gain or loss' under Section 202(c)(2) (42 Stat. 230)" (the reorganization section of the statute) *"does not toll the company's life as a continued venture* under Section 201," (the dividend section of the statute) "and that *what were 'earnings or profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earnings or profits' of the successor, or parent, in liquidation."* (Italics added.)

Commissioner v. Sansome is the leading case on the subject of the transfer of corporate earnings from one corporation to another corporation in a nontaxable reorganization, the principle established by that case being known as the Sansome Rule.

The principle that nontaxable reorganizations do not break the continuity of the corporate life as a continuing venture applies to consolidations of two or more corporations. In *Baker v. Commissioner*, 80 F.

(2d) 813 (C.C.A. 2, 1936), where a parent corporation consolidated five wholly owned subsidiaries into a new company, it was held that the earnings of the five subsidiaries were transferred intact to the successor corporation.

Many cases could be cited in support of this principle, but no purpose would be served in multiplying citations since there are no cases to the contrary,[5] and the Sansome Rule is now recognized as an established principle of income tax law. The principal cases are cited in par. 9.58 of Mertens' twelve-volume work on the Law of Federal Income Taxation. With respect to liquidations, Mertens states (Vol. I, pp. 507-8):

> "In a tax-free liquidation of a subsidiary into a parent corporation, the earnings or profits of the former are not considered distributed but simply transferred intact to the parent. The theory of continued identity of earnings obtains also where there is more than one transferor."

The tax-free liquidation of a subsidiary into a parent corporation was first permitted under the Revenue Act of 1936, which added subsection (6) to section 112(b) of the statute as it existed prior thereto.[6] The pertinent portion of this subsection reads as follows:

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[5]See, however, *Campbell v. U. S.*, 144 F. (2d) 177 (C.C.A. 3, 1944), holding the doctrine of the *Sansome* case inapplicable because of lack of continuity of proprietary interests, although the decision is also based on the ground that all earnings were distributed in cash as a part of the reorganization.

[6]Section 110(a) of the Act of 1935 (49 Stat. 1020) made a similar amendment to the 1934 Act, but this amendment was never actually effective, since it was applicable only to taxable years beginning after December 31, 1935, and was superseded by the Revenue Act of 1936.

"(6) **Property received by a corporation on complete liquidation of another.**—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation." (Set forth in full, Appendix, pp. ii-iv.)

Section 112(b)(6) as thus enacted continued in the same form in the Revenue Act of 1938 and thereafter in the Internal Revenue Code.

After the Sansome Rule became recognized as an established principle of income tax law, the Treasury Regulations were amended to incorporate this principle. Regulations 94, issued under the Revenue Act of 1936, contains the following provision:

"Art. 115-11. **Effect on earnings or profits on (of) certain tax-free exchanges and tax-free distributions.**—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization *or a complete liquidation under section 112(b)(6)* * * *), gain or loss was not recognized * * *, then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations." (Italics added.) (Set forth in full, Appendix, pp. ix-xi.)

The foregoing regulation applies by its terms to transactions other than the complete liquidation of a subsidiary corporation, but with respect to the complete liquidation of a subsidiary corporation, which of course necessarily results in the dissolution of the

subsidiary, it is obvious that the only "proper adjustment and allocation of the earnings or profits of the transferor" which can be made as between the transferor and transferee corporations is the transfer of all the earnings or profits of the subsidiary to the parent corporation. In this respect the regulation is but a recognition of the general principle referred to above as having been established by the cases, namely, that nontaxable reorganizations do not break the continuity of the corporate life as a continuing venture.

The quoted portion of Article 115-11 of Regulations 94 was continued without change in Regulations 101 relating to the Revenue Act of 1938 and Regulations 103 relating to the Internal Revenue Code. However, the following addition to Article 115-11 was made in 1938 by Regulations 101, and appeared immediately following the portion quoted above:

> "The general rule provided in section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:
>
> (1) * * *
>
> (2) The distribution in any taxable year (beginning before January 1, 1938, or on or after such date) of stock or securities, or other property or money, to a corporation *in complete liquidation of another corporation,* under the circumstances described in section 112(b) (6) of the Revenue Act of 1936 or section 112 (b) (6) of the Revenue Act of 1938.
>
> (3) * * *
>
> (4) * * *

> A distribution described in paragraphs (1), *(2)*, (3) or (4) above does not diminish the earnings or profits of any corporation. In such cases, *the earnings or profits remain intact and available for distribution as dividends* by the corporation making such distribution, or *by another corporation to which the earnings or profits are transferred* upon such reorganization or other exchange." (Italics added.) (Set forth in full, Appendix, pp. xiii-xvi.)

The addition thus made to the regulations in 1938 is merely a clarification of the portion of the regulation heretofore quoted (supra, p. 21) as it existed in 1936 and as continued in 1938. The portion of the regulation heretofore quoted could only mean, as applied to the complete liquidation of a subsidiary corporation, that the earnings or profits of the subsidiary would be transferred to the parent corporation. The addition made in 1938, quoted above, is more specific, and, as applied to the facts of our case, after stating that the distribution in liquidation by the three subsidiary corporations of Honolulu does not diminish the earnings or profits of the subsidiaries, continues with the statement that the earnings or profits remain intact and available for distribution as dividends by the corporation to which the earnings or profits are transferred, namely, Honolulu.

The addition to the regulations thus made in 1938 was continued without change in Regulations 103 as issued under the Internal Revenue Code.

Thus ever since the Revenue Acts have permitted the tax-free liquidation of subsidiaries, beginning with

the year 1936, the regulations have provided that the earnings or profits of the subsidiaries remain intact and are transferred to the parent corporation. At the same time the regulations also contained the following provision:

> "Gains and losses within the purview of section 112 or corresponding provisions of prior Acts *are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.*" (Italics added.)[7]
>
> (See Article 115-3 of Regulations 94 and 101 and Section 19.115-3 of Regulations 103, Appendix, pp. ix-xi.)

Section 112 of the Revenue Act of 1936 referred to in this regulation permits certain transactions, including the liquidation of subsidiary corporations, to be consummated without incurring income tax. This provision of the regulations is a companion provision to the provision referred to above (Article 115-11), and is part of the same general plan adopted by the regulations to synchronize the effect of tax-free reorganizations upon *earnings or profits* available for dividends, as distinguished from taxable net income. As applied to the liquidation of subsidiaries, for example, if a subsidiary had an earned surplus and its liquidation resulted in a profit to the parent, it is obvious that the earned surplus of the parent should not be increased by *both* the earned surplus of the subsidiary and the profit which is actually *realized* by the

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[7]This is the regulation approved by this Court in *Commissioner v. Wheeler*, ... U.S. ...., decided March 26, 1945.

parent, although not *recognized* for tax purposes.[8] Thus the regulations provide that the earned surplus will be transferred, but on the other hand realized profit (not recognized under section 112 as subject to tax) will not be taken into account in the computation of earnings or profits available for dividends.

What is the result if the subsidiary has an operating deficit and its liquidation results in a loss to the parent corporation?

(b) Under the doctrine of the Sansome case, that the continuity of the corporate life as a continuing venture is not broken, no valid distinction can be drawn between operating deficits on the one hand and earnings or profits on the other hand.

Before discussing the effect of an operating deficit in the transferor corporation, the meaning of the terms "earnings available for dividends" and "operating deficit" must be clearly understood. A corporation has earnings available for dividends if its profits, after deducting dividends declared out of profits, exceed its losses. In such case the balance of its earned surplus account will appear on the right-hand or credit side. Since the earned surplus account normally appears on the right-hand or liability side of the balance sheet, together with capital stock, paid-in surplus, and other "net worth" accounts, an earned surplus account with a balance on the right or credit side would be said to have a positive rather than a negative balance. On the other hand, a corporation has an operating deficit if its operating losses exceed its profits. In this case the balance in its earned surplus

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[8]See the examples under section I (c) of the Brief, infra, pages 38 to 44.

account will appear on the left-hand or debit side. Such a balance would be said to be a negative balance in the earned surplus account.

It will perhaps be helpful to illustrate the foregoing by the following simple examples:

Assume that X Company had earnings available for dividends on January 1, 1936, in the amount of $200,000, that its profits for 1936 were $50,000, and that it declared two $10,000 dividends during the year. Its earned surplus account would then appear as follows:

X Company

Earned Surplus

1936			1936		
June 1	Dividend	10,000	Jan. 1	Balance	200,000
Dec. 1	Dividend	10,000	Dec. 31	Profits, 1936	50,000
Dec. 31	Balance	230,000			
		250,000			250,000
			1937		
			Jan. 1	Balance	230,000

On the other hand, assume that Y Company had an operating deficit on January 1, 1936, in the amount of $100,000, and that its earnings for 1936 were $60,000. Its earned surplus account would then appear as follows:

Y Company

Earned Surplus

1936			1936		
Jan. 1	Balance	100,000	Dec. 31	Profits, 1936	60,000
			Dec. 31	Balance	40,000
		100,000			100,000
1937					
Jan. 1	Balance	40,000			

It will be seen that the balance of the earned surplus account of Y Company on January 1, 1936, appeared on the left-hand or debit side, indicating that it had no earned surplus but on the contrary an operating deficit in the amount of $100,000. It thus had a negative balance in its earned surplus account. It will also be seen that the profits for 1936 in the amount of $60,000 operated to reduce this negative balance or operating deficit to the amount of $40,000, the balance appearing on January 1, 1937. An operating deficit must be eliminated by subsequent earnings before there can be accumulated earnings or profits available for dividends (except that dividends may be paid from the current earnings of the taxable year). All the cases recognize this principle as basic. See for example, *Commissioner v. W. S. Farish & Co.*, 104 F. (2d) 833 (C.C.A. 5, 1939). Therefore an operating deficit cannot be disregarded or charged to some other account, but must be carried in the *earned surplus* account, in order that the books will clearly indicate at what point subsequent profits have eliminated this adverse

balance, after which additional profits will constitute earnings available for dividends.

To complete the picture we will assume that the following two balance sheets represent the condition of X Company and Y Company on January 1, 1936:

X Company

Balance Sheet, January 1, 1936

Assets		Liabilities	
Cash	5,000	Earned Surplus	200,000
Real Estate & Plant	1,495,000	Capital Stock	1,300,000
	1,500,000		1,500,000

Y Company

Balance Sheet, January 1, 1936

Assets		Liabilities	
Cash	5,000	Earned Surplus	100,000
Real Estate & Plant	1,195,000	Capital Stock	1,300,000
	1,200,000		1,200,000

It will be seen that the earned surplus of X Company appears in the foregoing balance sheet as a positive or black figure, whereas the earned surplus of Y Company appears as a negative or red figure. As has been heretofore stated, under the doctrine of the *Sansome* case as set forth in numerous judicial decisions and as incorporated in the Treasury regulations, it is clear that upon the liquidation of a subsidiary corporation its earnings or profits are transferred to the parent corporation. Can any dis-

tinction be drawn between earnings and profits which, as we have seen, represent a positive balance in the earned surplus account, and an operating deficit, which is a negative balance in the earned surplus account?

In the present case the three wholly owned subsidiaries of Honolulu had total operating deficits in the amount of $1,205,451.61, and Honolulu realized a loss upon the liquidation of these subsidiaries in the amount of $1,225,908.63 (the slight difference in these figures is explained in Footnote No. 1 on page 5 of the preceding petition). It is apparent that the earned surplus of Honolulu should not be reduced by both the loss which it realized upon the dissolution of these subsidiaries and the total operating deficits of the subsidiaries, since this would be a duplication of the same loss. It is also apparent that in order to avoid a substantial overstatement of the earned surplus of Honolulu it is necessary to reduce its earned surplus either by the loss realized or by the operating deficits of the subsidiaries.

Article 115-3 of the regulations (supra, p. 24) specifically refers to losses as well as gains, and provides that the loss realized by Honolulu will not reduce the earnings and profits of Honolulu because it was not recognized for tax purposes under section 112. On the other hand, the companion provision of the regulations, namely, Article 115-11 (supra, pp. 21-23), refers only to the transfer of the earnings or profits and not to the transfer of an operating deficit. These two articles, being part of the same general

plan to synchronize the effect of tax-free reorganizations upon earnings or profits available for dividends, must be read together. In view of the fact that Article 115-3 refers to losses as well as gains, it is quite possible that Article 115-11 should be interpreted to include operating deficits within the meaning of the words "earnings or profits". As we have seen, an operating deficit is but a negative balance in the earned surplus account, and such an interpretation would not be unreasonable.

We are merely suggesting but not insisting upon such an interpretation, since it is possible that the Treasury Department did not intend to go beyond the decided cases in promulgating this regulation. When the regulations first incorporated a provision relating to the transfer of earnings from one corporation to another in a nontaxable reorganization, which, as we have heretofore seen, occurred in 1936, the doctrine of the *Sansome* case had already become firmly established. The doctrine was recognized and discussed in Paul and Mertens' authoritative work on the Law of Federal Income Taxation (par. 8.45), which was published in 1934, but the doctrine of the *Sansome* case was not incorporated in Regulations 86, which appeared in 1935, and it was not until Regulations 94 were adopted in 1936 that this doctrine made its appearance in the provisions of Article 115-11 to which we have referred above. Thus the regulations merely followed the decided cases, which have dealt only with transferor corporations having earnings. None of the cases thus far decided has dealt with an operating deficit, and it is possible, therefore, that

the Treasury Department is waiting for decisions on this subject before expanding its regulations to definitely include operating deficits as well as earnings.

Since the principle upon which the transfer of earnings in a tax-free reorganization is based is that the *continuity of the corporate life as a continuing venture is not broken,* it is obvious that no logical distinction can be drawn between earnings and operating deficits. There is no magic in the figure being black rather than red. Suppose, for example, that X Company and Y Company, whose earned surplus accounts have been set forth above (pp. 26 and 27), were to reorganize by means of a nontaxable statutory merger. If in such case Y Company was the continuing corporation and therefore did not cease to exist, its operating deficit in the amount of \$100,000 would obviously not disappear but would continue on its books. On the other hand, the earnings of X Company in the amount of \$200,000 would be transferred intact to Y Company in accordance with the Sansome Rule. Thus the earned surplus of the combined companies after the merger would show earnings available for dividends in the amount of \$100,000, which would consist of the earnings of X Company less the operating deficit of Y Company.

If, on the other hand, X Company was the continuing corporation, then its surplus of \$200,000 would of course continue on its books. But the parties to this proceeding differ as to the treatment to be accorded the operating deficit of Y Company. It is petitioner's contention that, in accordance with the

principle of the Sansome Rule that the continuity of the life of Y Company as a continuing venture is not broken, the operating deficit of Y Company would be transferred to X Company, thus reducing the earnings available for dividends of the combined corporations to $100,000, and producing the same result as though Y Company had been the continuing corporation. On the other hand, the Government, in attempting to make a distinction between operating deficits and earnings or profits, would contend that the operating deficit of Y Company would *not* be transferred to X Company in the merger, with the result that the combined corporations would have earnings of $200,000 available for dividends. Thus the Government is forced into the position of contending *that a different result obtains, depending upon whether X Company or Y Company is the continuing corporation.* The results of tax-free mergers should certainly not depend upon such insubstantial differences.

Taking an illustration more closely paralleling the facts of the instant case, let us suppose one of the wholly owned subsidiaries of Honolulu had had earnings of $1,000,000 and the remaining two subsidiaries had total operating deficits of $2,205,451.61, making a net operating deficit for the three subsidiaries of $1,205,451.61, which is the actual total operating deficit of the three wholly owned subsidiaries that were liquidated. In such case Honolulu would have sustained the same loss on the liquidation of the three subsidiaries as it actually sustained upon the liquidation of its three wholly owned subsidiaries in 1936, and this

loss would have been substantially the same as the net operating deficits of the three subsidiaries in the total amount of $1,205,451.61. However, the Government, in accordance with the distinction that it attempts to make, would transfer the earned surplus of one of the subsidiaries, in the total amount of $1,000-000, but would refuse to permit the transfer of the operating deficits of the two other subsidiaries, in the amount of $2,205,451.61. Thus the earnings of Honolulu available for dividends would be *increased* by the amount of $1,000,000, whereas they should actually be *decreased* by the amount of $1,205,451.61. Not only is this result completely erroneous, but it is entirely illogical as well.

The illogical results to which the Government is forced in the two foregoing illustrations could be avoided by simply recognizing that earnings and operating deficits are both balances of the same account —one positive, the other negative. The illogical results flow from the Government's insistence on splitting the account down the middle and insisting that balances on one side of the middle are to be treated differently from balances on the other side.

Mertens in his new work on the Law of Federal Income Taxation states (Vol. I, p. 510):

> "Although there are no cases in point, the conclusions expressed above (relating to the transfer of earnings) would seem, if correct, to apply to the absorption of deficits of predecessor corporations as well as of surplus."

In conclusion, on this phase of the argument, it is recognized that the application of the Sansome Rule to *all* cases of tax-free reorganizations may also lead to illogical results—but if so, the results will be equally illogical whether operating deficits or earnings are involved. In other words, the illogical nature of these results will not be caused by treating operating deficits in the same manner as earnings, but rather may result from the application of the Sansome Rule to all cases of tax-free reorganizations. Mertens in the work just cited recognizes this possibility, and suggests that the test as to whether earnings are transferred to the successor corporation should not be the "tax-free" character of the so-called reorganization, stating that (Vol. I, p. 510):

> "any such general test would confuse the issue and give rise occasionally to absurd results in the various types of situations arising under our complex exchange and reorganization provisions. The proper test is whether there is substantial identity of the several corporations and continuity of proprietary interests."

This theory of Mertens is commented upon merely for the purpose of pointing out that even under this narrower application of the Sansome Rule, not adopted in any of the decided cases,[9] the principle of the *Sansome* case would apply to the facts of the instant case. The three subsidiaries of Honolulu

[9]Except that lack of continuity of proprietary interests was one of the grounds for the decision in *Campbell v. U. S.*, 144 F. (2d) 177. See Footnote 5, supra, page 20. Cf. *Robinette v. Commissioner*, ... F. (2d) .... (C.C.A. 9, March 19, 1945).

which were liquidated in 1936 were at all times wholly owned subsidiaries of Honolulu, and thus there was clearly "substantial identity of the several corporations and continuity of proprietary interests".

The argument that the operating deficits of these subsidiaries were absorbed by Honolulu applies, of course, with equal force to the acquistion by one of these subsidiaries, California Exploration Company, Inc., of the operating deficits of its two predecessors, also at all times wholly owned subsidiaries of Honolulu, which were carried forward on to the books of California Exploration Company, Inc. in the nontaxable consolidation which occurred in 1934. (See Petition herein, Summary Statement, supra, pp. 4 and 5.)

(c) Section 501 of the Second Revenue Act of 1940, and the Treasury Regulations expressing the same principles prior to the enactment of this section, will not operate in an equitable manner insofar as nontaxable liquidations of subsidiary corporations are concerned unless the Sansome doctrine applies to operating deficits as well as to earnings.

Ever since the issuance of Regulations 86 interpreting the Revenue Act of 1934, the Treasury Regulations have contained a sentence reading substantially the same as the following sentence from Article 115-1 of Regulations 86:

> "Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized under that section." (Set forth in full, Appendix, pp. viii-ix.) (See corresponding Article 115-3 of later regulations, quoted supra, p. 24.)

The substance of these successive regulations was enacted as section 501 of the Second Revenue Act of 1940. This section of the statute added subsection (l) to section 115 of the Internal Revenue Code, the pertinent portion reading as follows:

> "* * * gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—
>
> (1) * * *
>
> (2) * * *
>
> * * * shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made." (Set forth in full, Appendix, pp. vi-viii.)

In *Commissioner v. Wheeler*, ... U. S. ......, decided March 26, 1945, this Court held that the regulations which preceded the enactment of section 501 were a reasonable and valid exercise of the rule-making power. In so holding, the Court said:

> "Congress has determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences, and has clearly provided that gains and losses on such transactions shall not be recognized for income tax liability *but shall be taken account of later.* Sections 112, 113. It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits. Compare Commissioner v. Sansome, 60 F. (2d) 931, and see Sen. Rep. No. 2156, 74th Cong., 2d Sess. p.

19; H. R. Rep. No. 2894, 76th Cong., 3d Sess. p. 41. * * *" (Italics added.)

It is clear, therefore, that the basis of the decision in the *Wheeler* case is that recognition of gain or loss is deferred and that when taken account of for tax purposes at a later time, the effect upon earnings or profits available for dividends can at that time be likewise taken into account. But this is not true with respect to nontaxable liquidations of subsidiary corporations, where the recognition of gain or loss is *not* merely deferred—it is *never* entirely recognized for tax purposes,[10] and may, as in the instant case, receive no recognition whatever. This is so because the basis section of the statute (section 113(a)(15) of the Revenue Act of 1936 and of the Internal Revenue Code (Appendix, p. v)) provides that the basis of the property received by the parent from the subsidiary remains the same as it was in the hands of the subsidiary. This provision is necessary in order to prevent double taxation. On the subsequent sale of property acquired from the subsidiary the parent will pay a tax on all unrealized gains of the subsidiary (see A Co. immediately following), but no tax will be paid by the parent on the realized gains of the subsidiary on which the subsidiary has paid the tax. (See C Co. immediately following.)

The following simple examples will clearly show the effect of the basis section of the statute and section

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[10]This is true unless the subsidiary's operations have resulted in neither realized gain nor realized loss, as in the case of corporations A and X, infra, pages 39 and 42.

501 of the Second Revenue Act of 1940 upon the earnings or profits of a parent corporation on the liquidation of wholly owned subsidiary corporations, and the application in each example of the doctrine of the *Sansome* case.

We will first assume that the subsidiaries have been profitably operated. P Co., the parent, incorporates three subsidiaries, A Co., B Co., and C Co., invests $500,000 in each, and receives from each on liquidation assets of a value of $1,700,000. At liquidation A Co. has neither earnings nor operating deficit, B Co. has earnings of $400,000, and C Co. has earnings of $1,-200,000. Balance sheets at liquidation will thus be as follows:

A Co.

Assets	$ 500,000	Stock	$ 500,000
		Earned Surplus	ϕ
	$ 500,000		$ 500,000

B Co.

Assets	$ 900,000	Stock	$ 500,000
		Earned Surplus	400,000
	$ 900,000		$ 900,000

C Co.

Assets	$1,700,000	Stock	$ 500,000
		Earned Surplus	1,200,000
	$1,700,000		$1,700,000

Explanatory Comments.

A Co.

Since A Co. has neither earnings nor operating deficit, it follows that the increase in value of its assets from $500,000, the cost of the assets acquired with the original investment, to $1,700,000 has not been realized. Accordingly, the assets are still carried by A Co. at $500,000. Upon the liquidation, P Co. will realize a gain of $1,200,000 but this gain will not be recognized for tax purposes (section 112(b)(6)) and therefore section 501 prevents the increase of P Co.'s earnings by this realized gain. However, since the assets of A Co. retained their basis of $500,000 in the hands of P Co. (section 113(a)(15)), a gain of $1,200,000 will eventually be subjected to tax and will be reflected in P Co.'s earnings upon the sale of the assets for $1,700,000.[11] The correct result is reached without the application of the Sansome Rule.

B Co.

Since B Co. has earnings of $400,000, it follows that the book value of its assets has increased to $900,000. Since the assets are worth $1,700,000, the remaining $800,000 of the increase in value has not been realized by B Co. Upon the liquidation, P. Co. will realize a gain of $1,200,000 but this gain will not be recognized for tax purposes (section 112(b)(6)) and therefore section 501 prevents the increase of P Co.'s earnings

[11] If the assets are sold for more or less than $1,700,000 the result will still be correct, since the earnings of P Co. will then reflect an additional gain or loss realized while the assets are held by P Co.

by this realized gain. However, since the assets of B Co. retained their basis of $900,000 in the hands of P Co. (section 113(a)(15)), a gain of $800,000 will eventually be subjected to tax and be reflected in P Co.'s earnings upon the sale of the assets for $1,700,000. The remaining $400,000 increase in P Co.'s earnings (upon which B Co. has paid a tax), which is required in order to equal the $1,200,000 gain realized on the liquidation is accomplished by the transfer of B Co.'s earnings to P Co. at the time of liquidation under the Sansome Rule. Thus the correct result is reached by a combination of the basis section and the Sansome Rule.

C Co.

Since C Co. has earnings of $1,200,000, it follows that the book value of its assets has increased to $1,700,000, which is their actual value. Thus the entire increase in value has been realized by C Co. and a tax paid thereon. Upon the liquidation, P Co. will realize a gain of $1,200,000, but this gain will not be recognized for tax purposes (section 112(b)(6)) and therefore section 501 prevents the increase of P Co.'s earnings by this realized gain. Furthermore, since the assets of C Co. retained their basis of $1,700,000 in the hands of P Co. (section 113(a)(15)), no portion of the gain of $1,200,000 will ever be reflected in P Co.'s earnings as a result of the subsequent sale of these assets. The entire $1,200,000 increase in P Co.'s earnings which is required in order to equal the $1,200,000 gain realized on the liquidation is accomplished by the transfer of C Co.'s earnings to P Co.

at the time of liquidation under the Sansome Rule. Thus the correct result is reached by the application of the Sansome Rule alone.

It will thus be seen that where the subsidiaries have been profitably operated prior to their liquidation, the correct effect upon P Co.'s earnings is obtained under section 501 in all cases either by the operation of the basis section, or by the operation of the basis section in conjunction with the Sansome Rule, or by the operation of the Sansome Rule alone.

We will now assume that the subsidiaries have been operated at a loss. P Co., the parent, incorporates three subsidiaries, X Co., Y Co. and Z Co., invests $1,700,000 in each, and receives from each on liquidation assets of a value of $500,000. At liquidation X Co. has neither earnings nor operating deficit, Y Co. has an operating deficit of $400,000, and Z Co. has an operating deficit of $1,200,000. Balance sheets at liquidation will thus be as follows:

X Co.

Assets	$1,700,000	Stock	$1,700,000
		Earned Surplus	ϕ
	$1,700,000		$1,700,000

Y Co.

Assets	$1,300,000	Stock	$1,700,000
		Earned Surplus	400,000
	$1,300,000		$1,300,000

Z Co.

Assets	$ 500,000	Stock	$1,700,000
		Earned Surplus	1,200,000
	$ 500,000		$ 500,000

Explanatory Comments.

X Co.

Since X Co. has neither earnings nor operating deficit, it follows that the decrease in value of its assets from $1,700,000, the cost of the assets acquired with the original investment, to $500,000 has not been realized. Accordingly, the assets are still carried by X Co. at $1,700,000. Upon the liquidation, P Co. will realize a loss of $1,200,000, but this loss will not be recognized for tax purposes (section 112(b)(6)) and therefore section 501 prevents the decrease of P Co.'s earnings by this realized loss. However, since the assets of X Co. retained their basis of $1,700,000 in the hands of P Co. (section 113(a)(15)), a loss of $1,200,000 will eventually be recognized for tax purposes and be reflected in P Co.'s earnings on the sale

of the assets for ~~$1,700,000.~~ 500,000 The correct result is reached without the application of the Sansome Rule.

Y Co.

Since Y Co. has an operating deficit of $400,000, it follows that the book value of its assets has decreased to $1,300,000. Since the assets are worth $500,000, the remaining $800,000 of the decrease in value has not been realized by Y Co. Upon the liquidation, P Co. will realize a loss of $1,200,000 but this loss will not be recognized for tax purposes (section 112(b)(6)) and therefore section 501 prevents the decrease of P Co.'s earnings by this realized loss. However, since the assets of Y Co. retained their basis of $1,300,000 in the hands of P Co. (section 113(a)(15)), a loss of $800,000 will eventually be recognized for tax purposes and be reflected in P Co.'s earnings on the sale of the assets for $500,000. The remaining $400,000 decrease in P Co.'s earnings (taken by Y Co. for tax purposes) which is required in order to equal the $1,200,000 loss realized on the liquidation, can only be taken care of under the Sansome Rule, which should operate to transfer the $400,000 operating deficit of Y Co. to P Co. In such case the correct result will be reached by a combination of the basis section and the Sansome Rule.

Z Co.

Since Z Co. has an operating deficit of $1,200,000, it follows that the book value of its assets has decreased to $500,000, which is their actual value. Thus the entire decrease in value has been realized by Z Co.

and taken by it for tax purposes. Upon the liquidation, P Co. will realize a loss of $1,200,000, but this loss will not be recognized for tax purposes (section 112(b)(6)) and therefore section 501 prevents the decrease of P Co.'s earnings by this realized loss. Furthermore, since the assets of Z Co. retained their basis of $500,000 in the hands of P Co. (section 113(a)(15)) *no portion of the loss of $1,200,000 will ever be reflected in P Co.'s earnings* as the result of a subsequent sale of these assets. The entire $1,200,000 decrease in P Co.'s earnings which is required in order to equal the $1,200,000 loss realized on the liquidation can only be taken care of under the Sansome Rule, which should operate to transfer the $1,200,000 deficit of Z Co. to P Co. In such case the correct result will be reached by the Sansome Rule alone. The facts with respect to Z Co. are essentially the facts of this petition.

It is apparent from the foregoing examples, which cover every possible contingency with respect to the profitable or non-profitable operations of subsidiary corporations and their subsequent nontaxable liquidations, that section 501 of the Second Revenue Act of 1940 (adding section 115(l) to the Internal Revenue Code), taken in conjunction with section 113(a)(15) (the basis section) will in every case operate to produce the correct adjustment to the earnings or profits available for dividends of the parent corporation, if, and only if, the doctrine of the *Sansome* case is given full effect, including within the principle of that case operating deficits as well as earn-

ings. It is only to the extent that the gains or losses of the subsidiary have not been realized by the subsidiary, but are represented by appreciation or depreciation in the value of its assets, that the earnings of the parent will ultimately reflect the correct result. But in the great majority of cases where gains or losses have been realized by the subsidiary and are therefore reflected in its earned surplus account, the earnings of the parent which are available for dividends will never be correctly stated except through the application of the Sansome Rule, including therein operating deficits as well as earnings.

That Congress intended section 501 to operate in an equitable manner in all cases, and was of the opinion that it did so, is evident from the fact that by subsections (b) and (c) of section 501 (Appendix, p. viii) the amendment made to the Internal Revenue Code by this section was given retroactive effect as though it were a part of the Internal Revenue Code and of each of the prior Revenue Acts *for all taxable years.* Furthermore, it is clear that Congress was fully cognizant of the fact that section 501 was complementary to and must operate in conjunction with the doctrine of the *Sansome* case in order to produce the correct result. Thus in the report of the Senate Finance Committee (76th Congress, 3rd Session, Report No. 2114, p. 25) the Committee states:

> "Under various provisions of the Internal Revenue Code dealing with exchanges and *liquidations,* the transfer of the property by a corporation to another corporation results in the nonrecognition, in whole or in part, of the gain or

> loss realized by the transferor upon such transfer. In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and shall be considered to be earnings and profits of the transferee for tax purposes. *These principles are to be given full effect under section 501.* The requirement of section 501 that there shall be no increase *or decrease* in earnings and profits by reason of a wholly unrecognized gain *or loss* is but another aspect of the principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee." (Italics added.)

The principle referred to in the foregoing quotation is, of course, the doctrine of the *Sansome* case, and it seems apparent that Congress expected the principle of that case to apply to both sides of the earnings and profits account—that is, to include a negative as well as a positive balance. Otherwise, how could it be said that the principle of that case is to be given full effect under the requirement of section 501 that there shall be *no decrease* in earnings and profits by reason of a wholly unrecognized *loss?* As we have seen, it is only by deciding that the principle of the *Sansome* case is applicable to operating deficits as well as to earnings that section 501 will operate in an equitable manner and produce the correct result in all cases.

(d) The Court below erred in assuming that it was necessary for petitioner to prove what portion of the deficits of the subsidiaries occurred in the tax year 1936.

The Court below makes the statement that:

> "It is apparent that appellant has not maintained its burden of proof that any of the deficits occurred in the tax year 1936 * * *. It is hence not before us to consider whether any such deficits would be deductible from the profits of the parent corporation if they had occurred in the tax year 1936."

The Court in its opinion gave no reason for believing it material to show what portion of the deficits of the subsidiaries occurred in 1936, but was apparently influenced by the Government's argument in its brief that the inheritance by Honolulu of the operating deficits of the subsidiaries in 1936 will not reduce Honolulu's earnings for 1936. This argument is based on the assumption that section 115(a) of the Act of 1936 would prevent such a reduction. This section of the statute reads in full as follows:

> "(a) **Definition of Dividend.**—The term 'dividend' when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), with-

> out regard to the amount of the earnings and profits at the time the distribution was made."

The portion of this section relied upon by the Government is that part defining a dividend to include any distribution "out of the earnings or profits of the taxable year". These words do not limit in any manner the *determination* of the earnings or profits of the taxable year, but merely state that any distribution therefrom constitutes a taxable dividend. It is obvious that the loss of $1,225,908.63 actually realized by Honolulu upon the liquidation of the subsidiaries occurred and could only occur at the moment the subsidiaries were liquidated on August 31, 1936, at which time Honolulu received all the assets of the subsidiaries in exchange for all the stock of the subsidiaries. Honolulu's earnings for 1936 available for dividends were actually eliminated by this loss. (R. 38.) Since the loss realized on this exchange exceeded Honolulu's earnings available for dividends, the *excess* became an operating deficit of Honolulu, *and a 1936 operating deficit.* If this Court should hold that the principle of the *Sansome* case applies not only to inherited earnings, but also to inherited operating deficits, then it is equally obvious that this inheritance occurs and can only occur at the moment of liquidation. At that moment the entire accumulated operating deficits of the subsidiaries in the amount of $1,205,451.61 would be inherited by Honolulu, with the result that the earnings available for dividends would be eliminated *in exactly the same manner as they actually were elimi-*

nated by the loss sustained. Since these accumulated operating deficits exceeded Honolulu's earnings available for dividends, the *excess*[12] would become an operating deficit of Honolulu at that moment, *and necessarily a 1936 operating deficit of Honolulu.* Not only is this the obvious result; it is the only result which does not have absurd consequences.

In order to demonstrate the fallacy of the Government's assumption that the operating deficits of the subsidiaries, *even though inherited by Honolulu,* do not reduce its earnings for 1936, let us assume for the moment that this assumption is correct. If the earnings for 1936 are not reduced, the only possible alternative is that the earnings of Honolulu for prior years in which the losses were sustained by the subsidiaries must be reduced, since otherwise there would be no reduction whatever and the operating deficits could not have been inherited by Honolulu. But taxes have been paid by the stockholders of Honolulu on these prior annual earnings without taking the annual operating deficits of the subsidiaries into account. The stockholders could not have avoided the payment of these taxes because to take the deficits of the subsidiaries into account would require a disregard of the separate corporate entities of the subsidiaries—a result which is not sup-

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[12]The operating deficits *of the subsidiaries* do not as such become operating deficits *of Honolulu.* It is important to note that it is only the *excess* of such deficits over Honolulu's earnings which becomes an operating deficit *of Honolulu.* Thus it is impossible to earmark the resulting deficit of Honolulu as traceable to any particular annual deficit of the subsidiaries.

ported by any authority. Thus the Government is arguing for the proposition that the stockholders must pay taxes on the annual dividends for prior years without taking into account the losses of the subsidiaries, and at the same time that the earnings for 1936 are not reduced by these losses when transferred to the parent corporation, so that the stockholders *never* receive the benefit of the reduction in earnings.

The error in the Government's assumption becomes even more apparent if it be assumed that the subsidiaries had earnings rather than operating deficits. Suppose, for example, that Honolulu had incorporated a subsidiary in 1936, and that this subsidiary had earnings of $100,000 a year for the years 1936, 1937, 1938 and 1939. Assume that Honolulu had an operating deficit in the amount of $500,000 at the beginning of 1936, had yearly earnings of $1,000,000, and declared dividends of $1,100,000, in each of these years. Since the dividends of Honolulu in each of these years exceeded its earnings by $100,000, it follows that for this period of four years the stockholders of Honolulu will have received total capital distributions in the amount of $400,000. Assume further that in January, 1940, the subsidiary, which has an earned surplus of $400,000, liquidates, and that Honolulu has earnings of $1,000,000 in 1940, not taking into account the earned surplus of the subsidiary in the amount of $400,000 which was transferred to Honolulu under the Sansome Rule. Honolulu then declares total dividends of $1,400,000 in 1940. It will be of assistance to tabulate the foregoing figures as follows:

	HONOLULU			SUBSIDIARY
Year	Earnings	Dividends	Capital Distributions	Earnings
12/31/35	$ *500,000*			
1936	1,000,000	$1,100,000	$100,000	$100,000
1937	1,000,000	1,100,000	100,000	100,000
1938	1,000,000	1,100,000	100,000	100,000
1939	1,000,000	1,100,000	100,000	100,000
1940	1,000,000	1,400,000		

Since under the doctrine of the *Sansome* case the subsidiary's earnings in the amount of $400,000 had been transferred to Honolulu in 1940, it seems apparent that Honolulu's earnings for that year will be $1,400,-000 and not $1,000,000 as the Government assumes. (This certainly would be the result if the subsidiary's earnings had been transferred by the declaration of a dividend immediately prior to liquidation.) But let us suppose for the moment that the Government is correct and that the transfer of the subsidiary's earnings did not increase Honolulu's earnings for 1940. In such case the stockholders of Honolulu, having received distributions of $1,400,000 in 1940, which according to the assumption exceeded the available earnings by $400,000, will have received further capital distributions in the amount of $400,000. Since they had previously received capital distributions for the years 1936 to 1939, inclusive, in the amount of $400,000, their total capital distributions would thus be $800,000. This is obviously erroneous, since Honolulu and its subsidiary combined earned during the five years 1936 to 1940, inclusive, a total of $5,400,000, and distributed to Honolulu's stockholders $5,800,000. Thus the total capital distributions are only $400,000. The Govern-

ment could not correct this erroneous result by going back to the years 1936 to 1939 and disallowing the capital distributions of $100,000 in each of these years (which incidentally might be barred by the statute of limitations), because to contend that the earnings of the subsidiary in the amount of $100,000 in each year were available for dividends by Honolulu disregards the separate corporate entities, which, as we have stated, is not supported by any authority.

It seems apparent, therefore, that the liquidation of a subsidiary and the transfer of its earnings to the parent corporation results in increasing the earnings of the parent corporation for the year in which the liquidation occurred. The transfer of an operating deficit would necessarily result in the same manner, that is, in the reduction of the earnings for the current taxable year. Thus earnings or operating deficits of the subsidiary for prior years are obviously not prior years' earnings or operating deficits *of the parent*, but upon transfer on the dissolution of the subsidiary become current earnings or operating deficits of the parent. As stated heretofore, all transactions necessarily affect the earnings of the year in which they occur. To hold otherwise in the case of the transfer of a subsidiary's earnings or operating deficits results in a disregard of the corporate entity, since the only possible alternative is to segregate the earnings and losses of the subsidiary into the respective years in which they occurred and assume a corresponding effect upon the earnings of the parent. Such a disregard of the separate corporate entities is not supported by any authority.

II.

IF IT IS HELD THAT THE OPERATING DEFICITS OF SAID SUBSIDIARIES WERE NOT INHERITED BY HONOLULU, THEN IT IS CONTENDED IN THE ALTERNATIVE THAT THE LOSS REALIZED BY HONOLULU UPON THE LIQUIDATION OF SAID SUBSIDIARIES REDUCED THE EARNINGS OF HONOLULU AVAILABLE FOR DIVIDENDS.

(a) Section 501 of the Second Revenue Act of 1940 in its application to the facts of this case violates the provisions of the Sixteenth Amendment to the Constitution of the United States.

Honolulu sustained an admitted loss of $1,225,908.63 on the liquidation of its three wholly owned subsidiary corporations on August 31, 1936. This loss was sufficient to eliminate not only Honolulu's normal earnings for 1936 of $931,553.82, but also the earnings as of the beginning of the year of $139,631.26, with the result that the distributions made by Honolulu in 1936 were actually distributions of capital and not income to the recipient, except to the extent indicated in Footnote No. 2, supra, page 6 of the petition. To subject such distributions to the Federal income tax is clearly a violation of the Sixteenth Amendment to the Constitution of the United States. Although this contention was first specifically made in the Court below in the petition for rehearing, it was at all times argued, both in the District Court and in the Circuit Court of Appeals, that the distributions were actually distributions of capital and not income. The Courts below having held that petitioner must pay an income tax upon a return of capital, and having so held because of the provisions of section 501 of the Second Revenue Act of 1940, have necessarily decided that this statutory

provision is constitutional in its application to this particular situation. Whether the lower Court's application of this statute violates the provisions of the Sixteenth Amendment to the Constitution of the United States, insofar as petitioner and the other stockholders of Honolulu are concerned, is a matter necessarily involved in this case and therefore before this Court for decision.

(b) The attempted retroactive application of section 501 of the Second Revenue Act of 1940 violates the due process clause of the Fifth Amendment to the Constitution of the United States.

It has heretofore been conclusively shown (I(c) of this Brief, pp. 35 to 46) that section 501 of the Second Revenue Act of 1940 will not operate in an equitable manner insofar as nontaxable liquidations of subsidiary corporations are concerned unless the Sansome doctrine applies to operating deficits as well as to earnings. It has also been shown that Congress was fully cognizant of the fact that section 501 is complementary to and must operate in conjunction with the doctrine of the *Sansome* case in order to produce the correct result. (Supra, p. 45.) Furthermore, it seems clear that Congress was of the opinion that section 501 produces the correct result in all cases; otherwise it would hardly have provided that the amendment should operate retroactively *for all taxable years.* As has been shown, it is only by deciding that the principle of the *Sansome* case is applicable to operating deficits as well as to earnings that section 501 will operate in an equitable manner, and in such case there

can be no objection to its retroactive application. But if it is to be held that the Sansome Rule is limited to the inheritance of earnings and does not apply to the inheritance of an operating deficit, then it is contended that the retroactive application of the amendment made by section 501(a) of the Second Revenue Act of 1940, as provided by section 501(c), to a transaction occurring more than four years prior thereto, is confiscatory and invalid and a violation of the due process clause of the Fifth Amendment to the Constitution of the United States.

It is recognized that retroactive income taxes have been sustained as constitutional where their retroactivity is limited to the taxable year in which the statute is passed, or even to the preceding year already closed. Thus in *United States v. Hudson*, 299 U. S. 498 (1937), this Court said:

> "As respects income tax statutes, it long has been the practice of Congress to make them retroactive for relatively short periods so as to include profits from transactions consummated while the statute was in process of enactment, or within so much of the calender year as preceded the enactment; and repeated decisions of this Court have recognized this practice and sustained it as consistent with the due process of law clause of the Constitution."

And in *White Packing Company v. Robertson*, 89 F. (2d) 775 (C.C.A. 4, 1937), it was held that the Act of Congress approved June 22, 1936, imposing the so-called "windfall tax", was valid, although applying

to income received during the taxable year 1935, so as to be retroactive for a maximum period of about sixteen months.

In *Welch v. Henry*, 305 U. S. 134 (1938), a Wisconsin statute enacted in 1935 was upheld as constitutional, although it was given retroactive effect to 1933. After referring to the cases upholding income tax statutes given retroactive effect for the year of the session in which the taxing statute is enacted, and in some instances during the year of the preceding session, this Court upheld the Wisconsin statute on the ground that the regular session of the Wisconsin Legislature which preceded the enactment of the statute was the 1933 session. This Court said:

> "And we think that the 'recent transactions' to which this Court has declared a tax law may be retroactively applied, Cooper v. United States, 280 U. S. 409, 411, 50 S. Ct. 164, 74 L. Ed. 516, must be taken to include the receipt of income *during the year of the legislative session preceding that of its enactment.* (Italics added.)
>
> * * * * * * *
>
> While the Supreme Court of Wisconsin, 223 Wis. 319, 271 N. W. 68, 72, thought that the present tax might 'approach or reach the limit of permissible retroactivity', we cannot say that it exceeds it."

In view of the foregoing authorities it would seem that section 501(b) of the Second Revenue Act of 1940, making the amendment to the Internal Revenue Code contained in section 501(a) retroactive for the

effective period of the Code, that is to say, to January 1, 1939, covers a period which is "recent" and is therefore a proper exercise of the legislative power. With respect to section 501(c), however, which purports to make the amendment operative *for all prior years,* if it should be held that the operating deficits of its subsidiaries were not transferred to Honolulu, then it is contended that a serious inequity results and that section 501(c) is confiscatory in so far as this appellant is concerned, and in violation of the due process clause of the Constitution.

CONCLUSION.

The doctrine of the *Sansome* case is peculiarly applicable to the nontaxable liquidation of the three wholly owned subsidiaries of Honolulu because they meet the suggested narrower test of substantial identity of the several corporations and continuity of proprietary interests.

It is of general importance in the administration of the revenue laws that this Court should determine whether the principle of the *Sansome* case is applicable so as to transfer an operating deficit on the nontaxable liquidation of a subsidiary corporation, or whether in the case of such liquidations the regulation approved in *Commissioner v. Wheeler,* ...... U. S. ...... (March 26, 1945), is unreasonable and invalid and section 501 of the Second Revenue Act of 1940 unconstitutional.

Wherefore, it is respectfully submitted that a writ of certiorari should issue as prayed for in the petition herein.

Dated, San Francisco, California,
May 16, 1945.

LEON DE FREMERY,
Attorney for Petitioner.

(Appendix Follows.)